BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FRANK G. AND JOAN CADENASSO)

For Appellants: E. Paul Rogers

For Respondent: Bruce W. Walker
Chief Counsel

Jean Harrison Ogrod
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Frank G. and Joan Cadenasso against proposed assessments of additional personal income tax in the amounts of $862.28, $304.38 and $773.44 for the years 1972, 1973 and 1974, respectively.

The two issues for determination are: (1) whether appellants are entitled to an abandonment loss deduction for the removal of fruit and nut trees from land which they owned: and (2) whether appellants are entitled to deduct the cost of preparing land for planting grapevines and the cost of the vines as a current trade or business expense.

Appellants own and operate a vineyard and winery in Solano County. Mr. Cadenasso's family has been growing grapes and producing wine for generations, and appellants' principal source of income is from the sale of grapes and wine.

On March 4, 1969, appellants purchased approximately 80 acres of land near their ranch. The newly acquired land, commonly referred to as the Baldwin Ranch, was improved with peach, prune and walnut trees. There were approximately 74 trees to the acre. The purchase agreement reflected a total purchase price of $112,000. The parties allocated $48,000 to the land and $64,000 to the fruit and walnut trees.

On the same date, appellants leased the property back to the seller for a term of six years, commencing November 1, 1969. Under the terms of the lease, the seller was to pay as rent 25 percent of the gross receipts from the sale of any crops grown on the ranch and was to bear the cost of labor and equipment necessary for the production and harvesting of crops grown on the premises. Appellants were to pay property taxes and assessments, bear the cost of furnishing water for irrigation of trees and crops and pay for all sprays and fertilizers used on the premises. Appellants could remove any dead or diseased trees at their own cost.

Information from the University of California Extension's Farm Advisor for Solano County indicates that during the mid-1960's peach growers without special outlets had gradually become unable to compete on a commercial basis with San Joaguin Valley growers and many had shifted to other crops, such as grapes or row crops. The Farm Advisor also indicated that in the 1960's a fungus rendered many of the pear trees in Solano County nonproductive.

In 1975 respondent audited appellants' 1972, 1973 and 1974 returns and inspected appellants' property. Upon inspecting the Baldwin Ranch, respondent found that approximately 38.5 acres of fruit trees had been torn out and replaced with grapevines. Respondent's inspection also indicated that the remaining trees were in poor condition. Based on the size of the grapevines growing on the land at the time of inspection, respondent concluded that 25.5 acres formerly planted in fruit trees had been planted in grapevines during 1972 and another 13.0 acres formerly planted in fruit trees had been planted

in grapevines in 1973. Therefore, respondent concluded that 25.5 and 13.0 acres of fruit trees had been removed before or during 1972 and 1973, respectively. Despite repeated'requests, appellants have declined to produce any evidence tending to establish when these trees were removed. The Solano County Assessor's Office has stated that additional fruit trees were removed by 1975 and 1976 and that a house had been moved onto the property.

As a result of the audit, respondent disallowed the depreciation deductions claimed on appellants' 1972, 1973 and 1974 returns on the fruit trees which, had been removed prior to those years. After being informed of the depreciation adjustment, appellants did not contest the disallowance but claimed that they should be allowed abandonment losses for the trees that were removed.

Respondent also determined that certain costs incurred in 1972 for the purchase of grapevines, grapestakes, budwood and grape cuttings, and in 1974 for land preparation and grapevines should have been capitalized instead of deducted as current expenses. Appellants have not challenged the determination for 1972 but maintain that the costs incurred during 1974 were properly deductible as a current expense.

The first issue is whether appellants are entitled to an abandonment loss pursuant to section 17206 of the Revenue and Taxation Code. Section 17206 provides, in pertinent part:

> (a) There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> (b) For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in Section 18041 for determining the loss from the sale or other disposition of property.
>
> (c) In the case of an individual, the deduction under subsection (a) shall be limited to--
>
> (1) Losses incurred in a trade or business ....

Under certain circumstances, when the usefulness of a depreciable asset used in a taxpayer's business ceases before the cost of the asset has been fully recovered, the taxpayer may recover his remaining basis by claiming an abandonment loss pursuant to section 17206 in the year the asset is'abandoned. The burden of 'establishing his right to claim a deduction for an abandonment loss is, of course, on the taxpayer. (New

Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 13481 (1934); Appeal of Jorge and Elena de Quesada, Cal. St. Bd. of Equal., Feb. 5, 1,968.)

In order to claim the deduction, the taxpayer must establish1 that the abandonment occurred as the result of a plan formed after the acquisition of the property that was abandoned. (First National Bank and Trust Co. of Chickasha v. United States, 462 F.2d 908, 909 (10th Cir. 1972); Eaton v. Commissioner, 81 F.2d 332 (9th Cir. 1935); Rev. Rul. 69-62, 1969-1 Cum. Bull. 58; Cal. Admin. Code, tit. 18, reg. 17206(c), subd. (2).) Where the taxpayer purchases real property and improvements, and at the time of purchase intends to abandon the improvements, he is not 'allowed a loss deduction under section 17206 on account of the eventual abandonment of the improvements, but must allocate the basis of the improvements to the underlying land. (Wood County Telephone Co., 51 T.C. 72 (1968); Cal. Admin. Code, tit. 18, reg. 17202(c).) The rationale for this rule is based upon the proposition that if a taxpayer has the intention, at the time of purchase, to abandon an improvement on real property, he obviously is interested in acquiring only the land. For that reason, the basis of the abandoned property is allocated to the land, thereby reflecting the actual intention of the purchaser. (Wood County Telephone co., supra, at 78-79.)

Whether the taxpayer purchased the property with the intention of abandoning the trees is a factual question. The determination of this issue is to be made from a consideration of all the facts and circumstances existing in the'case. (Cal. Admin. Code, tit. 18, reg. 17206(c), subd. (3).) A review of the extremely sketchy record before us compels a conclusion that appellants have failed to carry their burden of establishing that the intent to remove the fruit and nut trees from the Baldwin Ranch was formed subsequent to the purchase. On the contrary, for-the reasons which follow, we are convinced that appellants had formed the intention to remove the trees prior to the acquisition of the Baldwin Ranch.

Respondent's inspection of the Baldwin Ranch revealed that by 1972 or 1973 almost half of the 80 acres of fruit and-nut trees had already been removed and the area planted with grapevines. Further information indicated that additional trees were removed in later years. Some of the trees were peach and others were pear. The record indicates that during the years in issue, peaches were commercially unprofitable and pears suffered from a fungus rendering them unproductive. As a result of these two factors, many peach and pear growers switched to other crops. We also note that for generations the Cadenassos had been growing grapes and producing wine. There is no evidence that appellants had ever grown fruit and

nuts commercially. Similarly, the record is silent as to whether appellants ever received any income from the sale of fruit or nuts by their tenant during the term of the Baldwin Ranch lease. Furthermore, appellants have failed to offer any evidence tending to establish that their intent to remove the trees from the Baldwin Ranch was formed after the purchase despite repeated requests to do so. Thus, we conclude that, prior to the acquisition of the Baldwin Ranch, appellants intended to remove the trees in order to increase their grape growing capacity.

Appellants contend that during the protest proceedings, respondent's representative offered to allow the claimed abandonment losses if appellants agreed to the other proposed adjustments. Although appellants did not agree to all of the proposed adjustments, they now appear to argue that because of the alleged offer, respondent is estopped from disallowing the abandonment losses.

As a general rule, estoppel is invoked against governmental entities only where grave injustice would otherwise result. (California Cigarette Concessions, Inc. v. City Of Los Angeles, 53 Cal. 2d 865, 869 [3 Cal. Rptr. 675, 350 P.2d 715] (1960).) Since estoppel is an affirmative defense, the burden is on the party asserting it to establish the facts necessary to support it. (Appeal of Richard W. and Ellen Campbell, Cal. St. Bd. of Equal., Aug. 19 1975; Appeal of Lee J. and Charlotte Wojack, Cal. St. Bd. of Equal., March 22, 1971.) In order to warrant application of the doctrine of estoppel, appellants must show that they relied to their detriment on respondent's alleged representation. This they cannot do since the facts upon which their tax liability is predicated arose before respondent's alleged representation. (See, e.g., Appeal of Arden K. and Dorothy S. Smith, Cal. St. Bd. of Equal., Oct. 7, 1974.)

If, in the alternative, appellants are contending that they entered into a final settlement agreement with respondent such argument is also without merit. A prerequisite to a binding settlement agreement is strict compliance with the statutes authorizing such agreements. (See Rev. & Tax. Code, §§ 25781 & 25781a; see also Auerbach Shoe Co., 21 T.C. 191 (1953), aff'd 216 F.2d 693 (1st Cir. 1954); Appeal of International Wood Products Corp., Cal. St. Bd. of Equal., Feb. 19, 1974.) Appellants have neither alleged nor presented facts sufficient to establish the existence of any agreement conforming to the requirements of sections 25781 and 25781a. Under these circumstances, we must conclude that no such agreement was reached.

The final issue for resolution is whether appellants were entitled to deduct the cost of preparing land for planting grapevines and the cost of the vines planted as a current trade or business expense or whether the expenditure should have been capitalized. The expenditures which appellants contend were deductible in 1974 consisted of $2,205 for land clearing,, bulldozing and leveling and $1,365 for grapevines.

California law permits the deduction of ordinary and necessary business expenses paid or incurred during the taxable year. (Rev. & Tax. Code, § 17202.) However, deductions for capital expenditures are not permitted. (Rev. & Tax. Code, § 17283.) In general, a capital expenditure is an expenditure that creates or results in the acquisition, permanent improvement or betterment of an asset that has a useful life substantially greater than one year. (Cal. Admin. Code, tit. 18, reg. 17283, subd. (b)(l).) Expenditures for the clearing,, leveling and conditioning of land in preparation for growing crops are capital expenditures. (H. L. McBride, 23 T.C. 901 (1955); Thompson and Folger Co., 17 T.C. 722 (1951).) Similarly, the costs of acquiring fruit trees, and other crop bearing plants with a life expectancy of substantially more than one year are capital expenditures which are not currently deductible.\ (H. L. McBride, supra; Thompson and Folger Co., supra.)

Appellants argue that the grapevines planted in 1974 were replacement vines planted in an existing vineyard and, therefore, the expense is deductible currently. Although appellants have suggested no authority for this proposition, their argument suffers from a more basic infirmity. Appellants have offered absolutely no evidence to establish that the grapevines planted in 1974 were replacement vines. The very nature of the expenses claimed, involving for the most part land preparation expenses, indicates that the expenses were incurred to establish a new vineyard, not to replace vines in an existing vineyard. We conclude that appellants have failed to carry their burden of'proving that they were entitled to deduct as current trade or business expenses the expenditures incurred in 1974 for land preparation and grapevines.

For the reasons set forth above, we conclude that respondent's action in this matter must be sustained.

Appeal of Frank G. and Joan Cadenasso

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding,, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED,' pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Frank G. and Joan Cadenasso against proposed assessments of additional personal income tax in the amounts of $862.28, $304.38 and $773.44 for the years 1972, 1973 and 1974, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of April, 1979, by the State Board of Equalization.

_____ Chairman

_____, Member

_____, Member

_____, Member

_____, Member